

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 02-39**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Application of sales and use taxes to products used as promotional items by a manufacturer and distributor.

SCOPE

Revenue rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue rulings are advisory in nature and are not binding on the Department.

FACTS

The Taxpayer is manufacturer and distributor incorporated in [STATE – NOT TENNESSEE], with two divisions that operate manufacturing facilities and/or warehouses in Tennessee. The Taxpayer sells products from its Tennessee inventory to wholesalers and retailers throughout the United States. These products are either manufactured in Tennessee or are purchased from third party vendors located outside Tennessee. The Taxpayer obtains the appropriate resale certificates from its customers to exempt its sales from the sales tax.

In addition, the Taxpayer occasionally removes from its Tennessee inventory products to be used in sales promotions throughout the United States. The Taxpayer does not resell products manufactured or purchased from third party vendors to be used as promotional items. Instead, products used as promotional items are shipped directly to [INDIVIDUALS] throughout the United States free of any charge.

One of the Taxpayer's divisions in Tennessee (hereinafter Division A) maintains product inventory in Tennessee warehouses, but does not manufacture any of the products it resells. Instead, the products sold by Division A are manufactured by third party vendors located outside Tennessee. These third party vendors ship Division A's purchases directly to Division A's Tennessee warehouse. The products are then stored temporarily in Tennessee before being further shipped throughout the United States.

A second division of the Taxpayer (hereinafter Division B) operates manufacturing facilities, in addition to maintaining warehouses in Tennessee. Division B manufactures products in Tennessee that are stored as inventory in its Tennessee warehouses. Division B, like Division A, also purchases some of its inventory from third party vendors located outside Tennessee. These third party vendors ship Division B's purchases directly to Division B's Tennessee warehouses. Products sold by Division B are also stored temporarily in Tennessee before being further shipped throughout the United States.

The Taxpayer has previously remitted use tax on the cost of all the products removed from its inventory that are not sold but used in sales promotions by Division A and Division B throughout the United States. In the case of products manufactured by Division B in Tennessee and used in sales promotions throughout the United States, the Taxpayer has utilized its "Budgeted Standard Cost" of [X %] to establish the cost of the component materials.

QUESTIONS

What sales or use taxes, if any, are due on the promotional items shipped from the Taxpayer's warehouses?

RULINGS

1. The Taxpayer is liable for sales or use taxes¹ on the cost of materials used to manufacture products that are used as promotional items outside Tennessee. The appropriate tax base is the actual cost of the materials, but generally accepted accounting principles may be used to calculate the cost.
2. The Taxpayer is liable for use taxes based on the fair market value (in no case less than the cost plus direct labor and overhead necessary to fabricate the items) of promotional items it manufactures in Tennessee and ships for use in Tennessee.
3. The Taxpayer is liable for sales or use taxes on the cost of products, not manufactured by the Taxpayer, but purchased from third parties for use as promotional items in Tennessee.
4. The Taxpayer is liable for sales or use taxes on the cost of products purchased from out-of state vendors for temporary storage in Tennessee, and later shipment for use as promotional items outside Tennessee; provided the sale, i.e. transfer of title or possession, to the Taxpayer takes place in Tennessee. However, temporary storage in Tennessee of

¹ In *Texas Eastern Transmission Corp. v. Benson*, 480 S.W.2d 905 (Tenn. 1972), the Supreme Court considered application of the tax to a purchaser to be a "sales tax" not a "use tax" when the sale took place in Tennessee. However, generally the tax levied on the purchaser is considered to be a use tax. Accordingly, the ruling refers to application of the tax to the Taxpayer as a sales or use tax when a sale may have taken place in Tennessee.

products purchased outside Tennessee pending shipment to non-residents is not a taxable event.

ANALYSIS

1. Promotional Items Manufactured by the Taxpayer in Tennessee and Shipped To Locations Outside Tennessee.

The application of the sales or use taxes to products that are either manufactured or imported for export begins with Tennessee's special statutory exemption or exclusion:

It is not the intention of this chapter to levy a tax upon articles of tangible personal property imported into this state or produced or manufactured in this state for export.

Tenn. Code Ann. § 67-6-313(a). This exemption provides taxpayers protection from application of Tennessee sales or use taxes that exceeds the requirements of the Commerce Clause. However, Tennessee case law indicates a sale or other intervening taxable event may negate the application of this exemption.

In *Board of Publication of Methodist Church, Inc. v. Woods*, 609 S.W.2d 501 (Tenn. 1980), the Court considered application of the predecessor to this exemption statute that also included a specific exemption for "bona fide interstate commerce." The prior statute, Tenn. Code Ann. § 67-3007, provided:

It is not the intention of this chapter to levy a tax upon articles of tangible personal property imported into this state or produced or manufactured in this state for export; nor is it the intention of this chapter to levy a tax on bona fide interstate commerce. It is, however, the intention of this chapter to levy a tax on the sale at retail, the use, the consumption, the distribution, and the storage to be used or consumed in this state of tangible personal property after it has come to rest in this state and has become a part of the mass of property in this state.²

The taxpayer, a publishing house in Nashville, delivered certain catalogs it had printed to a mailing service as agent of its out-of-state purchaser, Camping World Inc., a retailer. The mailing service then affixed mailing address labels to the catalogs and directly mailed them to out-of-state addressees of former customers of Camping World, Inc. These catalogs were not resold, but were provided free of charge to customers of Camping World, Inc. to promote future orders of merchandise. The Court determined this case was factually distinguishable from *Young Sales Corp. v. Benson*, 450 S.W.2d 574 (Tenn. 1970) and *Beecham Laboratories v. Woods*, 569 S.W.2d 456 (Tenn. 1978). These two earlier cases involved application of the import for export exemption, but in neither case was there an allegation that a sale, i.e. transfer of title or possession, took place in Tennessee. *Id.* at 504. The Court said in this case a taxable event occurred and no

² The first clause of the first sentence of this prior statute is now codified as Tenn Code Ann. § 67-6-313(a). The second clause of the first sentence is no longer included in the statutes. The second sentence is now codified as Tenn. Code Ann. § 67-6-211.

exemption existed under the statute or the Commerce Clause of the United States Constitution. *Id.* at 505. Since there was a transfer of possession in Tennessee, the sales tax applied even though the immediate exportation of the catalogues was contemplated.

In a subsequent case, *Jack Daniel Distillery, Lem Motlow, Prop. v. Jackson*, 740 S.W.2d 413 (Tenn. 1987), the Court considered the application of the import for export exemption upon advertising materials imported to the taxpayer's warehouse and then exported for use outside Tennessee. These advertising materials were purchased from the taxpayer's subsidiary located in Tennessee, and title to the advertising materials passed to the taxpayer in Tennessee. The Court stated:

Appellant also argues that even if a sale took place at the time of transfer of title from [its subsidiary] the transaction was exempt from sales tax under the "import-for-export" exemption set forth in T.C.A. § 67-6-313.

It is not the intention of this chapter (Sales and Use Taxes) to levy a tax upon articles of tangible personal property imported into this state or produced or manufactured in this state for export; nor is it the intention of this chapter to levy a tax on a bona fide interstate commerce.

The import-for-export exemption from sales tax does not apply when the transfer of title is from a vendor located in Tennessee to a purchaser also located in Tennessee even though the purchaser intends to and does export the merchandise. *See Board of Publication of the Methodist Church, Inc. v. Woods*, 609 S.W.2d 501 (Tenn.1980).

Id. p. 416.

It can be seen from these two cases that a sale of tangible personal property in Tennessee, i.e. a transfer of title or possession, breaks the chain of events necessary for application of the import-for-export or manufacture-for-export exemption.

Of course, the seller and the purchaser in both cases were located in Tennessee, and the goods sold were outside the "stream of interstate commerce" at the time of the Tennessee sale. Therefore, the Court determined neither the prior statutory exemption for "bona fide interstate commerce", nor the Commerce Clause provided an exemption under the facts presented. *See Board of Publication of the Methodist Church, Inc. v. Woods*, 609 S.W.2d 501,504 (Tenn.1980).

One year later, the Court again considered application of the import/export exemption in *Nasco, Inc. v. Jackson*, 748 S.W. 2d 193 (Tenn. 1988). This case is even closer to the facts presented by the Taxpayer in this ruling. The taxpayer in *Nasco* was engaged in the manufacture and sale of various types of sporting goods and other merchandise upon which it placed logos and emblems of many of its customers, such as high school bands and other groups. The taxpayer also produced brochures in Tennessee that it distributed to its customers both within and without Tennessee. The Court held the taxpayer was required to pay sales tax on the cost price of purchased components of the advertising

brochures it manufactured in Tennessee. In this case, the taxpayer had purchased large quantities of paper, ink, film, chemicals and other tangible products without the payment of tax by utilizing its resale certificate. The Court said:

Had it not been for appellant's resale certificate, the Tennessee vendors to appellant would have been required to collect sales taxes when they sold to appellant, and *appellant would have been liable for use taxes upon purchases which it made from vendors in other states.*

Appellant claims exemption under the provisions of T.C.A. § 67-6-313(a) which provides:

"It is not the intention of this chapter to levy a tax upon articles of tangible personal property imported into this state or produced or manufactured in this state for export;..."

Appellant relies upon the case of *Beecham Laboratories v. Woods*, 569 S.W.2d 456 (Tenn.1978), in which the taxpayer was allowed an exemption for pharmaceutical samples which were to be distributed to its salesmen in other states.

...

In *Beecham*, the Court was concerned with the use of the materials after their fabrication or importation, not with the transactions by which the taxpayer acquired the components.

In the present case, the taxpayer acquired the component goods and services without being charged either a sales or a use tax. It did not acquire them for resale, but for its own use. Under those circumstances the rules of the Commissioner and the statutes dealing with component parts do not exempt the purchases by the taxpayer. The statute relied upon by the taxpayer, as construed in *Beecham*, would exempt the activities of their storage and exportation which otherwise might constitute taxable privileges.

Id. at 195,196. (Emphasis mine).

Though *Nasco* did not explicitly overrule *Beecham Laboratories v. Woods*, 569 S.W.2d 456 (Tenn.1978), it severely limited its application. In *Beecham*, the Department of Revenue had attempted to impose a use tax on drug samples manufactured and then stored in Tennessee prior to shipment to salesmen throughout the United States. Use tax was assessed on the fair market value of the samples not the cost of component materials. *See*: Tenn. Code Ann. § 67-6-209(a). In *Beecham* the import-for-export exemption applied,³ but *Nasco* indicates *Beecham* would have been decided differently had the

³ However, the Court said there was no exemption for drug samples distributed in Tennessee. *Beecham Laboratories v. Woods*, 569 S.W.2d 456, 458.

Department sought to assess tax on the cost of the components instead of the fair market value of the fabricated drug samples.

Unlike the earlier cases, the taxpayer made no argument in *Nasco* that the Commerce Clause or the “bona fide interstate commerce” provision in the statute at the time applied to exempt the transaction. Clearly, a sales or use tax levied against a purchaser upon the cost of components used to manufacture items in Tennessee meets the challenge of the four-prong Commerce Clause test of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed. 2d 326 (1977).⁴

The facts in *Nasco* are very similar to those presented by the Taxpayer. The *Nasco* Court upheld application of the sales or use taxes to component materials obtained from out-of-state vendors as well as in-state vendors over the taxpayer’s objections that the import-for-export exemption of Tenn. Code Ann. § 67-6-313(a) should apply. *Nasco* makes no distinction in application of the use tax based on whether the sale (transfer of title or possession) actually took place in Tennessee. This is important because this was a distinction previously used to break application of the import for export provision in both *Board of Publication of Methodist Church, Inc. v. Woods*, 609 S.W.2d 501 (Tenn. 1980) and *Jack Daniel Distillery, Lem Motlow, Prop. v. Jackson*, 740 S.W.2d 413 (Tenn. 1987). Since *Nasco* is directly on point with the facts related concerning the Taxpayer’s manufacture of promotional items in Tennessee for use outside Tennessee, the cost of the component materials for promotional items will be subject to sales or use taxes.

2. Promotional Items Manufactured for Use in Tennessee

In the case of the promotional items, not shipped out of state, but used as promotional items in Tennessee, neither Tenn. Code Ann. § 67-6-313(a) nor the *Nasco* case apply. Items manufactured, not for resale, but for the use of the Taxpayer in Tennessee are subject to the use tax on the fair market value of the manufactured item. Tenn. Code Ann. § 67-6-209(a). The fair market value of products used as promotional items is the amount the Taxpayer would have received if the products were sold by the Taxpayer. However, in no event will the fair market value be less than the cost of materials, plus the labor and overhead necessary for the fabrication of the promotional items. TENN. COMP. R. & REGS. 1320-5-1-1.03.

3-4. Promotional Items Purchased For Use.

Products purchased by the Taxpayer, stored in Tennessee and later shipped for use in Tennessee are not exempted by Tenn. Code Ann. § 67-6-313(a). Sales or use taxes apply based on the cost of these promotional items shipped to persons in Tennessee.

⁴ Whether “physical presence” of an out-of-state taxpayer is required in order to satisfy the “substantial nexus” prong of the *Complete Auto* test remains for determination. See: *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn.Ct.App.1999), appeal denied, (Tenn. May 8, 2000), cert. denied, *Johnson v. J.C. Penney*, and *America Online, Inc. v. Johnson*, 2002 WL 1751434 (Tenn.Ct.App.).

Any sale of promotional items to the Taxpayer in Tennessee, i.e. transfer of title or possession in Tennessee, will be subject to sales or use taxes no matter where the promotional items may be used. A sale in Tennessee negates application of the import-for-export exemption of Tenn. Code Ann. § 67-6-313(a). *Board of Publication of Methodist Church, Inc. v. Woods*, 609 S.W.2d 501 (Tenn. 1980), and *Jack Daniel Distillery, Lem Motlow, Prop. v. Jackson*, 740 S.W.2d 413 (Tenn. 1987) both indicate this result when the seller is in Tennessee. It seems equally clear that a sale in Tennessee by an out-of-state vendor to the Taxpayer would also negate application of the exemption.⁵ It is the sale in Tennessee of tangible personal property that negates application of Tenn. Code Ann. § 67-6-313(a), not the presence of the vendor in Tennessee.

One last category of tangible personal property must be considered under this exemption statute. These are products purchased by the Taxpayer out-of-state with storage in Tennessee, and later used as promotional items out-of-state. The plain language of the statute indicates the exemption should apply in this case since there is no sale, manufacture of products, or other taxable event in the state, save the temporary storage of products pending export. Nonetheless, it is at least arguable that *Nasco* may indicate a different conclusion. In *Hearthstone, Inc. v. Hardy Moyers*, 809 S.W.2d 888 (Tenn. 1991), the Court's comments seem to indicate that Tenn. Code Ann. § 67-6-313(a) only applies to tangible personal property that is exported for resale.

In *Nasco, Inc. v. Jackson*, 748 S.W.2d 193 (Tenn.1988), we held that this statute does not create an exemption from taxation for personal property exported for the taxpayer's use in another state. But we have never held that Tenn.Code Ann. § 67-6-313(a) creates no exemption for personal property exported for resale, because to do so would render that statute meaningless.

Id. at 891. Despite any doubt as to the application of the import-for-export exemption, a later enactment⁶ amending the definition of “storage” clearly applies to exempt application of use taxes when the only taxable event in the state is storage.

“Storage” means and includes any keeping or retention in this state of tangible personal property for use or consumption in this state, or for any purpose other than sale at retail in the regular course of business; *provided, that temporary storage pending shipping or mailing of tangible personal property to non-residents of Tennessee shall not constitute a taxable use in Tennessee;*

Tenn. Code Ann. § 67-6-102(28). (Emphasis mine). The broad definition of “storage” contained in the first clause of the quoted statute was part of the Sales and Use Tax Law prior to the Tennessee cases previously discussed. However, the emphasized proviso of the second clause was not enacted until 1995. Since storage is the only taxable event in

⁵ Under *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed. 2d 326 (1977) there are no longer any Constitutional barriers to application of the sales or use tax to a Tennessee purchaser under these circumstances. Also, the statutory exemption for “bona fide interstate commerce” has been removed.

⁶ 1995 Tenn. Pub. Acts 168, Section 2.

Tennessee that could possibly apply to this last category of products used by the Taxpayer, the exception of Tenn. Code Ann. § 67-6-102(28) is controlling. Accordingly, the temporary storage of these products by the Taxpayer prior to shipment to non-residents is not a taxable use.

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